Office of Chief Counsel
Internal Revenue Service

memorandum

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EWJohnson

date: OCT [illegible]

to: Paul Ferber, International Examiner

from: Associate Area Counsel, LMSB, St. Paul

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subject: **Application of Reorganization Statutes to Foreign Restructuring Distribution**

This memorandum is in response to your request for advice of March 30, 2000, as supplemented on June 29, 2000, and on various later dates.

ISSUE

Whether under the facts provided the distribution of stock of a controlled corporation by a corporation without taxable E&P to its shareholder reduces the shareholder's basis in the stock of the distributing corporation by the *fair market value* or by the *basis* of the stock in the distributed corporation.

CONCLUSION

The shareholder's basis in the stock of the distributing corporation is reduced by the fair market value of the stock in the distributed corporation.

FACTS

[redacted]. ([redacted]) is a United States corporation in the insurance business.

After several transactions, [redacted] and its subsidiaries, prior to [redacted], were positioned as follows. [redacted] owned [redacted], a [redacted] corporation. [redacted] in turn owned [redacted] ([redacted]) and [redacted], both United Kingdom corporations. [redacted] in turn owned [redacted], a United Kingdom corporation. [redacted] in turn owned several other United Kingdom corporations. See diagram #1.

On [redacted], [redacted] distributed its stock in [redacted] to [redacted] to achieve the position shown in diagram #2 ('the distribution').

At the time of the distribution, the fair market value of the [redacted] stock was approximately $[redacted]. The basis of the [redacted] stock was approximately $[redacted].

At the time of the distribution, [redacted] had E&P of approximately $[redacted], all of which was previously taxed income under I.R.C. §951.

The taxpayer's position is that the distribution reduces [redacted]'s basis in its [redacted] stock by the $[redacted] *fair market value* of the [redacted] stock distributed.

The agent suggests that the distribution reduces [redacted]'s basis in its [redacted] stock by the $[redacted] *basis* of the [redacted] stock distributed.

On [redacted], [redacted] sold its stock in [redacted] to an unrelated third party ('the sale') and reported a capital loss of approximately $[redacted] on the sale. If the agent's suggestion is correct, [redacted]'s basis in its [redacted] stock prior to the sale would be $[redacted] lower, and thus the amount of the capital loss on the sale would be $[redacted] less than as claimed by the taxpayer, or $[redacted].

The distribution was made as one of a series of steps taken in contemplation of the sale.

DISCUSSION

Where property other than money is distributed by a corporation, the amount of the distribution is the fair market value of the property. I.R.C. §301(b)(1).

A distribution is a taxable dividend to the shareholder only to the extent of E&P. I.R.C. §§301(c)(1), 316(a). A distribution in excess of E&P is a return of capital; the shareholder does not have taxable income, but the stock basis is reduced by the distribution. I.R.C. §301(c)(2).

If a distribution is made out of E&P, but the E&P is previously taxed income under I.R.C. §951, again the shareholder does not have taxable income, but the stock basis is reduced by the distribution. I.R.C. §§959(a), 961(b)(1).

In this case it is agreed that, without regard to the reorganization statutes, the distribution would reduce [redacted]'s basis in [redacted] by the $[redacted] *fair market value* of the [redacted] stock distributed as claimed by the taxpayer, because [redacted] had no taxable E&P at the time of the distribution.[1]

The agent suggests that application of the reorganization statutes requires that [redacted]s basis in its [redacted] stock is reduced by the $[redacted] *basis* of the [redacted] stock distributed as opposed to the $[redacted] fair market value.

The reorganization statutes are not applicable in this case.

The appropriate reorganization statute for consideration on these facts is I.R.C. §355, which involves treatment of a corporate distribution of a controlled subsidiary. Application of I.R.C. §355 requires 'continuity-of-interest', which means that the distributing and the distributed corporations must remain substantially in the control of the persons that owned the distributing corporation prior to the distribution. See, Reg. §1.355-2(c). The step-transaction doctrine applies in determining whether there is continuity-of-interest, e.g. if the distribution is made in contemplation of later sale of the

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[1] In the facts provided there was also mention of [redacted]s giving up some of its stock in [redacted] in return for the [redacted] stock. It is assumed if the distribution was technically a redemption, that the redemption would be subject to dividend treatment under I.R.C. §302.

distributing or distributed corporation to an unrelated third party, there is no continuity-of-interest. McDonalds Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

In this case, the distribution was made in contemplation of the eventual sale of the distributing corporation to an unrelated third party. There is no continuity-of-interest, and thus no application of I.R.C. §355.

In any case, application of I.R.C. §355 would not lead to the result suggested by the agent. The flush language of I.R.C. §355(a) essentially states that the distribution is not a taxable dividend, and although the point is not directly addressed in the statute, in the case of a distributing corporation without taxable E&P, the logical conclusion is that there is *no* corresponding 'return-of-capital' reduction in the shareholder's basis in the distributing corporation on the distribution.[2]

REID M. HUEY
District Counsel

By: ______________________
ERIC W. JOHNSON
Attorney

[2] See, Reg. 1.358-1 Example (where I.R.C. §355 distribution in excess of E&P, no mention of reduction of basis for such excess, except to the extent of recognized boot). There might be some reduction in [redacted]'s basis in its [redacted] stock because some of this basis would be reallocated to the [redacted] stock, but such a reduction is computed without reference to the basis of the [redacted] stock prior to the distribution. See, I.R.C. §358; Reg. §1.358-1 and -2.